88-1429

Supreme Court, U.S.
FILED
FEB 15 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. _____

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1988

Clayton E. DeVoe, Petitioner

v.

The Commissioner of the Internal Revenue Service

ON APPEAL FROM THE NINTH CIRCUIT COURT OF APPEALS;

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATED SUPREME COURT

PETITION FOR WRIT OF CERTIORARI

J.R. RILEY, ESQ.
COUNSEL FOR PETITIONER
P.O. BOX 2013
MISSOULA, MONTANA 59806
(406) 549-1208

GARY R. ALLEN
CHIEF, APPELLATE SECTION
TAX DIVISION
DEPARTMENT OF JUSTICE
P.O. BOX 502
WASHINGTON D.C. 20044
FOR RESPONDENT

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Clayton E. DeVoe, the Petitioner herein, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit filed in this matter.

QUESTION PRESENTED

Whether the Commissioner of Internal Revenue upon disallowing a taxpayer's deduction taken under one section of the Internal Revenue Code, must allow alternate tax treatment for the expenditure, when proper under another part of the same section of the Internal Revenue Code and corresponding Regulations, and such alternate treatment is known; AND whether the U.S. Tax Court, when affirming the Commissioner's disallowance as noted above, must grant the alternate tax treatment when it is aware of such treatment; AND whether the Circuit Courts of Appeal must grant the alternate treatment when the Tax Court was

aware of the alternate treatment but failed to grant it.

PARTIES

All parties to this action are listed in the caption on the cover page.

TABLE OF CONTENTS

PAGE

OPINIONS BELOW 6

JURISDICTION.....6

STATUTES INVOLVED 7

STATEMENT OF CASE 6

REASONS FOR GRANTING WRIT.....16

APPENDIX A..... 22

TABLE OF AUTHORITIES

PAGE

CASES

Stradlings Building Materials, Inc. v. Commissioner, 76 T.C. 84, (1981).....12

Burns v. Commissioner, 78 T.C. 185 (1982)...13

New Colonial Ice Co. v. Helvering, 290 U.S. 435 (1934).....16

McCarthy v. U.S., 394 U.S. 459, 89 S.Ct. 1166 19

STATUTES

28 U.S.C. 2101(c)..... 6

26 U.S.C. 7482 7

26 U.S.C. 263(c) 7, 8, 11, 12, 13, 15

26 U.S.C. 7433 21

Income Tax Regulation 1.612-4.8,11, 12, 13, 15

RULES

Supreme Court Rule 20.4 6

U.S. Tax Court Rule 13 7

U.S. Tax Court Rule 190-192 7

Federal Rules of Appellate Procedure 13,14..7

MISCELLANEOUS

American Jurisprudence 2nd Ed. 18, 19

OPINIONS BELOW

The October 14th, 1988 opinion of the Ninth Circuit Court of Appeals, whose judgment is herein sought to be reviewed, is not reported, but a copy of said opinion accompanies this Petition in the separate Appendix "A" to this Petition as Exhibit # 1. The prior September 24, 1986 memorandum opinion of the United States Tax Court also accompanies this Petition in the separate Appendix "A" as Exhibit # 2.

STATEMENT OF THE CASE

JURISDICTION

The judgment of the Ninth Circuit Court of Appeals was filed on October 14th, 1988. A timely petition for rehearing was denied on the 2nd day of December, 1988. A copy of said denial accompanies this Petition in the Separate Appendix "A" as Exhibit #3. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. Section 2101(c) and U.S. Supreme Court Rule 20.4. This case arose on appeal by

Petitioner to the United States Tax Court from the Internal Revenue Service's final determination and notice of deficiency dated September 28, 1982 regarding tax years 1978, 1979, and 1980, pursuant to the provisions of Rule 13(a) and (b) of the United States Tax Court Rules. The deficiency was then increased by the Commissioner in an amendment to Answer, filed at trial on November 5, 1984. The Tax Court upheld the amended deficiency, and Petitioner appealed to the United States Court of Appeals for the Ninth Circuit pursuant to the provisions of 26 U.S.C. Section 7482, Federal Rules of Appellate Procedure 13, and 14, and United States Tax Court Rules 190-192.

STATUTORY PROVISIONS INVOLVED

This case involves the provisions of 26 U.S.C Section 263(c) and related Income Tax Regulations Section 1.612-4. Section 263(c) of Title 26 of the United States Code, in pertinent part, provides:

> Notwithstanding subsection (a), regulations shall be prescribed by the Secretary

> under this subtitle corresponding to the regulations which granted the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells and which were recognized and approved by the Congress in House Concurrent Resolution 50, Seventy-ninth Congress.

Income Tax Regulations Section 1.612-4 in pertinent part, provides:

> (a) Option with respect to intangible drilling and development costs. In accordance with the provisions of section 263(c), intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land whether as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of oil and gas properties may at his option be chargeable to capital or to expense. ...

STATEMENT OF FACTS

Originally, before the Tax Court, this case involved two separate transactions

entered into by Petitioner; one in 1978 regarding a license to distribute and sell a medical instrument; and second, a transaction in 1979 regarding a one percent of a Seventy-Three percent net working interest in each of two oil and gas wells. These wells were drilled in 1979, and began producing in 1980 and continue to produce today. This Petition involves the complete disallowance of any deduction or capitalization regarding the latter transaction, and failure of either the Commissioner of Internal Revenue, the U.S. Tax Court, or the Court of Appeals, to grant the alternate capitalization, provided for by the Income Tax Code and Regulations.

Regarding the latter transaction, on June 25th, 1979 an entity known as J. & D. Enterprises of Billings, Montana entered into two documents denoted as "Letter Agreement" whereby L.G. Williams Oil Company, Inc. granted J. & D. Enterprises an undivided two percent of a Seventy-Three percent net working interest in oil and gas leases covering two parcels of

land in Canadian County, Oklahoma. Petitioner's interest in the leases was noted on the signature line of these "Letter Agreements". Further, there were two additional "Letter Agreements" setting forth Petitioner's one percent interest also dated June 25th, 1988. In addition, the parties stipulated the fact that Petitioner acquired his interest in these wells on or about June 25, 1979. (See, Exhibit #2, p. 71).

On October 1, 1979 Petitioner, by personal check, paid to J.& D. Enterprises Ten Thousand Seven Hundred Sixty Dollars ($10,760.00). On August 7, 1980 J.& D. Enterprises executed two "Assignments" to Petitioner further acknowledging his one percent interest.

On December 30, or 31, 1979 Petitioner received documents from L.G. Williams Oil Company (the driller) showing the actual tangible and intangible drilling costs, other costs and administrative expenses incurred in drilling the two wells, and showing Petitioner's share of those expenses.

This transaction was not in relation to any tax shelter or otherwise questionable activity by Petitioner. In fact, both of the oil and gas wells have been producing since 1979, and Petitioner has received and declared income from the wells each and every year since 1979.

On his 1979 tax return, Petitioner made a timely election under 26 U.S.C. Section 263(c) and related Income Tax Regulations 1.612-4, to deduct the intangible drilling and development costs currently. (See Exhibit # 2, p.39) The amount deducted was Ten Thousand One Hundred Sixty-Eight Dollars ($10,168.00), which was substantially less than the amount shown on the documents received from L.G. Williams Oil Company as his share of the expenses, but being the amount determined by his accountant as deductible. In 1980 Petitioner deducted Three Hundred Dollars ($300.00) for depreciation regarding the wells.

The Commissioner of Internal Revenue disallowed all of the above deductions and

depreciation in his September 28, 1982 notice of deficiency. The Tax Court upheld the Commissioner's disallowance, because it found that Petitioner had failed to show that the Commissioner's determination was incorrect or that the above noted expenditure to J.& D. Enterprises fit the four criteria required to support a current deduction under its holding in Stradlings Building Materials, Inc. v. Commissioner, 76 T.C. 84, 86 (1981). (See, Exhibit # 2, p. 71). This, despite the fact that it was stipulated by the parties that Petitioner actually made the expenditure to J.& D. Enterprises, and that he had acquired an interest in the two oil and gas leases on or about June 25, 1979. (See Exhibit #2, p. 71).

On appeal to the Ninth Circuit Court of Appeals regarding this transaction, Petitioner argued that even if the Tax Court's decision was correct regarding the current deduction of the expenses, that under 26 U.S.C. Section 263(c) and Income Tax Regulations 1.612-4

Petitioner should be allowed to capitalize the expenditure to J.& D. Enterprises. He argued that the question of capitalization of the expenditure was before the Tax Court based on the reading of the Opinion on pages 28 and 29, where the Tax Court noted that:

> "Section 1.612-4, Income Tax Regs., which implements section 263(c), provides an option to capitalize or to deduct currently intangible drilling expenses incurred in the development of gas or oil properties. The election is available only to an "operator", who is defined as one who holds a working or operating interest in any tract or parcel of land either as a full owner or under a lease or any other form of contract granting working or operating interests. It is not sufficient if a taxpayer merely supplies the money to pay for drilling in exchange for an oil payment. In such cases, the taxpayer would have to capitalize his expenditures as acquisition costs of a nonoperating interest. Burns v. Commissioner, 78 T.C. 185 (1982)."

(See, Exhibit # 2, pp.61-62).

The Court of Appeals denied Petitioner's argument that he should be allowed to capitalize his expenditure to J.& D. Enterprises even if the current deduction was incorrect, on grounds that the issue was not raised before the Tax Court. (See, Exhibit #1, p.61). Should this Petition be granted, the transcript will show that during oral argument, the Justices of the Court of Appeals further stated that no one had held that Petitioner could not capitalize the expenditure. However, the Commissioner's current position is, that barring any change by this Court, the Court of Appeals decision bars capitalization of the expenditure to J.& D. Enterprises for any of the tax years involved in the case. (See, Exhibit #4 in the separate Appendix "A" hereto p.81). Consequently, Petitioner is left in the incongruous position of receiving and declaring all income from the oil and gas wells, without ever having been allowed any deduction, or capitalization, for his acquisition and/or development costs regarding these wells.

Petitioner asserts that, given the facts noted above, and, that there is no real dispute that the expenditure to J.& D. Enterprises comes within the capitalization provisions of 26 U.S.C. Section 263(c) and Income Tax Regulations Section 1.612-4, then either the Commissioner of Internal Revenue, the U.S. Tax Court, or the Court of Appeals, must grant capitalization of the expenditure, and that the Commissioner must recompute the deficiency allowing for such capitalization.

The issue presented appears to be one of first impression, and essentially goes to the question of whether or not the Commissioner of Internal Revenue, or Courts (U.S. Tax Court, Court of Appeals, or other Courts) must grant taxpayers alternate tax treatment regarding an expenditure, where the treatment employed by the taxpayer is disallowed, and the alternate treatment is clearly applicable, and known both to the Commissioner and to the courts.

REASONS FOR GRANTING THE WRIT

Certiorari should be granted to resolve the conflict between the result in this case, and the provisions of the statute and related regulations, and to establish a policy in income tax cases which ensures that the statutory and regulatory provisions are embodied in the results of contested cases. The statute unambiguously provides that the expenditure at issue is either currently deductible as an expense, or may be capitalized_ 1/ The Tax Court recognized this fact in its opinion, as quoted above. Unquestionably taxpayers bear the burden of proving entitlement to a deduction taken__2/, and deductions are a matter of legislative grace__3/. However, Petitioner asserts that where, as here, an expenditure properly comes within one of two

---

1. See, Exhibit #2, pp.28-29
2. See, U.S. Tax Court Rule 142(a)
3. New Colonial Ice Co. v. Helvering, 290 U.S. 435, 440 (1934)

alternate tax treatments under a statute and regulations, and the Commissioner disallows the treatment employed by the taxpayer, and the Tax Court finds there was insufficient proof of entitlement to the treatment employed; then either the Commissioner or the Courts must grant the taxpayer the alternate treatment if proper. This must be the policy, to avoid depriving taxpayers of the tax treatment provided for by congress. This is especially true, where the Commissioner, and the Courts, are aware of the alternate treatment. Here, by its own opinion, the Tax Court understood that the alternate treatment was available to the taxpayer.

Further, as the tax law and regulations become ever more complicated, and are radically changed by congress from time to time, those charged with administration of the laws, and adjudication of disputes regarding them, must be required to ensure that taxpayers receive the benefits provided under the law, and not just the burdens imposed by them. As a matter

of policy, taxpayers should not be denied a proper tax treatment regarding an expenditure, when the Commissioner of Internal Revenue and the Courts are aware of an alternate treatment.

The proper function of courts is to administer justice in accordance with the established rules of law.__4/ The function of the Internal Revenue Service is both to administer, and ensure compliance with, the tax laws and regulations. Where the law and regulations provide for alternate treatment of an expenditure, as a matter of policy disallowance of one treatment, should never be allowed to foreclose the alternate treatment when it is clearly applicable. That is the result of this case which Petitioner seeks to have this Court address. Neither the Commissioner of Internal Revenue, nor the Courts, have administered justice or the law in this case. Rather, should this Petition be denied, they

---

4. See, 20 Am.Jur. 2d, Courts, Section 64, and cases cited there,under footnote 4, and 5.

have operated to deprive Petitioner of a proper treatment of the expenditure, by failing to grant Petitioner the treatment provided by the law and regulations.

In support of the policy that the Internal Revenue Service, and Courts should be required to inform taxpayers of, and grant them applicable alternative treatments provided by law and regulations, this Court's attention is drawn to parallel requirements in other areas of the law. In criminal law, suspects must be advised of their legal rights upon arrest. Similarly, Courts must advise criminal defendants of the legal implications of a guilty plea and of his other legal rights before accepting a plea of guilty. 5/ Although this is a civil law question, a similar policy should be applied, namely, that taxpayers should be advised, by the Internal

---

5. McCarthy v. United States, 394 U.S. 459, 89 S.Ct. 1166, and Rule 11, Federal Rules of Criminal Procedure and many cases decided regarding that rule. See also, 20 Am.Jur.2d Criminal Law, section 479.

Revenue Service, and/or the Courts, of alternative tax treatments which are available regarding an expenditure, when denying taxpayers' treatments which are deemed, or found to be, inappropriate. In that way, both the Internal Revenue Service and the Courts will administer justice and the laws, which is their proper function.

In another related area, the problem of taxpayers being denied the protection and provisions of the law in the area of tax collection has, finally, been addressed by Congress. The Technical and Miscellaneous Revenue Act of 1988, (PL 100-647, 11/10/88) included the "Taxpayers Bill of Rights" (PL 100-647, Subtitle J, Sections 6226-6247.) Under this act, a taxpayer may bring a civil action for damages against the United States in a United States district court if an officer or employee of the Internal Revenue Service recklessly or intentionally disregards any provision of the Internal Revenue Code or any regulation thereunder in connection with

the collection of any federal tax with respect to that taxpayer.__6/ The policy asserted here would enhance the policy of this new law, by requiring the Internal Revenue Service, and/or the Courts to advise and grant taxpayers appropriate alternative treatments of an expenditure provided for under the Internal Revenue Code and regulations thereunder.

CONCLUSION

For the reasons stated above, Petitioner respectfully prays that a writ of Certiorari be granted.

J. R. Riley

J.R. Riley, Esq.
Attorney for Petitioner
P.O. Box 2013
Missoula, Montana 59806
(406) 549-1208

---

6. See, Internal Revenue Code Section 7433, 26 U.S.C. Section 7433.

APPENDIX A

EXHIBIT #1

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

CLAYTON E. DEVOE,	)	
	)	NO. 87-7372
Petitioner-Appellant,	)	Tax Ct. No. 0977-6
vs.	)	
	)	MEMORANDUM *1/
COMMISSIONER INTERNAL REVENUE SERVICE,	)	FILED 10/14/88
	)	
Respondent-Appellee.	)	
	)	

Appeal from a decision of the Tax Court of the United States

Argued and Submitted: October 6, 1988
San Francisco, California

Before: BROWNING, WALLACE, BRUNETTI, Circuit Judges.

Petitioner appeals the Tax Court's decision that petitioner lacked the requisite profit motive to entitle him to any business deduction under 26 U.S.C. 162 or amortization under 26 U.S.C. 1253(d) for a medical equipment license tax shelter. Factual findings of the

---

1. * This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 36-3

United States Tax Court are reviewed under the "clearly erroneous" standard. Polakof v. C.I.R., 820 F.2d 321, 323 (9th Cir. 1987). The Tax Court did not clearly err in its determination that petitioner did not have the required profit motive to qualify the license as a trade or business.

Petitioner also appeals the Tax Court's disallowance of expenses for 1979 and 1980 from an interest in two oil wells. Petitioner conceded that he did not submit the appropriate proof for deductibility. Additionally, the Tax Court did not clearly err in its findings that Petitioner did not submit the requisite proof. Id. Taxpayer asks in the alternative that he be allowed to capitalize the money he actually spent on the wells. Petitioner failed to raise this issue in the Tax Court below and this court will not consider an issue raised for the first time on appeal. Bolker v. C.I.R., 760 F.2d 1039, 1042 (9th Cir. 1981). The Tax Court's decision is affirmed.

AFFIRMED.

EXHIBIT #2

T.C. Memo. 1986-477

UNITED STATES TAX COURT

CLAYTON E. DEVOE, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 29360-82 Filed September 24, 1986

J. Robert Riley, for the petitioner.

R. Alan Lockyear, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HAMBLEN, Judge: Respondent determined deficiencies in petitioner's Federal income tax as follows:

Year Ended	Deficiency
December 31, 1978	$39,946.00_1/

1. In the statutory notice of deficiency dated September 28, 1982, respondent determined a deficiency for petitioner's taxable year 1978 of $11,511. However, in the amendment to answer filed at trial on November 5, 1984, respondent increased the deficiency for 1978. As a result, respondent bears the burden of proof as to the increases. Rule 142(a), Tax Court Rules of Practice and Procedure. By denying the total $57,892 of alleged expenses on Schedule C of petitioner's 1978 return, petitioner's income is increased by $46,498.00 above the determination in the statutory notice of deficiency. Thus, petitioner's deficiency for 1978 is increased from $11,511 to $39,946. In the amendment to answer, respondent also denied interest expense in 1979 which increased petitioner's income by $11,510 above the determination made in the statutory notice. In the statutory notice, respondent had allowed petitioner an interest expense deduction of $11,510 which allowed petitioner an interest expense deduction of $11,510 which petitioner had not claimed on the return. However, respondent did not increase petitioner's 1979 deficiency because, despite the adjustment, petitioner still had negative taxable income for 1979 which results in a minimum tax of $744 on accelerated depreciation on leased personal property associated with neither the medical equipment license nor the oil and gas interest.

In his statutory notice of deficiency, respondent allowed a tentative investment tax credit of $570 for petitioner instead of a $278 amount shown on petitioner's 1980 return. Neither petitioner nor respondent addressed this allowance or the minimum tax deficiency for taxable year 1979 on brief. Since respondent's determination is presumptively

December 31, 1979	744.00
December 31, 1980	$18,095.00

The primary issues for determination are (1) whether petitioner is entitled to claim certain deductions with respect to his investment in a medical equipment license and (2) whether petitioner is entitled to deductions for depreciation, intangible drilling and completion cost, administration expense and miscellaneous expenses in relation to his interest in two oil and gas leases.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts, the first and second supplemental stipulation of facts, and attached exhibits are incorporated herein by this reference.

Petitioner resided in Missoula, Montana,

---

correct, petitioner failed to satisfy the burden of proof. Rule 142(a), Tax Court Rules of Practice and Procedure. As a result, we sustain respondent's allowance and deficiency on these two issues.

when he filed his petition in this case. Petitioner's main occupations are farming and real estate.

Medical Equipment License

In 1978, petitioner's accountant, Bob Bragg, informed him that Bragg knew of a good investment which would be of interest to petitioner. Soon thereafter, Robert Aldridge ("Aldridge"), president of a concern by the name of North Star One, contacted petitioner by telephone with an investment opportunity. North Star One, located in Hayden Lake, Idaho, advertises itself on its letterhead as a promoter of "tax shelters and precious gems." Aldridge explained to petitioner that he had a model of an instrument for the treatment of hemorrhoids by the name of Proctotherm. Proctotherm is a therapeutic instrument, invented by Roger Q. Estes and James S. Latenser in 1976 or 1977, to shrink and to provide temporary relief from the pain of hemorrhoids.

A corporation by the name of Bio-tronics, Inc.

("Bio-tronics") owns the right to all title and interest to file for a patent and to fabricate, manufacture or construct the Proctotherm._2/

On or about December 20, 1978, petitioner entered into a License Agreement with Bio-tronics. Under the License Agreement, Bio-tronics granted to petitioner the exclusive license to promote, distribute, market, and sell the Proctotherm in a specific geographic area. Petitioner's geographic area was Area 65, located in Central North Carolina, and was comprised of 41 marketing units. The fee for the license was $184,500 (41 units time

---

2 The original patent and manufacturing rights to "Proctotherm" were sold to a partnership called Proctotherm Limited Partnership on April 1, 1977. On May 8, 1978, Proctotherm Limited Partnership transferred its Proctotherm assets to a new corporation called Thermo-tronics Incorporated. On November 21, 1978, Thermo-tronics Incorporated changed its corporate name to Bio-tronics Incorporated. Although Bio-tronics has since changed its name to Theratech, Inc., and the name of the device has been changed from "Proctotherm" to "Thermotherapy", we will refer throughout the opinion to the corporation as "Bio-tronics" and the device as the "Proctotherm."

$4,500), payable in cash and two promissory notes. With the execution of the License Agreement, petitioner paid $10,250 in cash ($250 time 41 units). In addition to the cash payment, petitioner executed two promissory notes at the time of the agreement. The first note, with a due date of March 15, 1979, is for the amount of $12,300 ($300 times 41 units) at six percent interest. Petitioner characterizes this note as recourse in nature. The second note, with a due date of December 31, 1985, is a nonrecourse promissory note in the amount of $161,950 ($3,950 times 41 units). The payments on the nonrecourse note are to be made when the product is sold, the amount of the payments determined by multiplying the number of units sold and $4.00.

In addition to the License Agreement with Bio-tronics, petitioner signed a Security Agreement and an Advertising Pool Agreement. Under the Security Agreement, Bio-tronics

> shall look <u>solely</u> to the property and assets covered by this Agreement

> for the performance of Debtor's (petitioner's) Obligations hereunder and in no event shall Debtor (petitioner) be personally liable for the Obligations hereunder. In the event of any default hereunder, no deficiency or other personal judgment shall be rendered or entered against Debtor (petitioner) with respect to the Obligations contained herein. (Emphasis supplied)

An "Obligation" is defined in the Security Agreement as:

> any and all loans, indebtedness, liabilities and obligations of any kind owing by the Debtor (petitioner) to Secured Party (Bio-tronics) however evidenced. * * * all indebtedness, obligations and liabilities under the License Agreement, Notes, and/or any Advances which may be made by Secured Party. (Bio-tronics) (Emphasis supplied.)

Under the Advertising Pool Agreement, petitioner agreed to pay the amount of $5,125, to Bio-tronics for a national advertising campaign payable $2,050 ($50 times 41 units) in cash and $3,075 ($75 times 41 units) in the

form of a promissory note due May 15, 1979, bearing a six percent rate of interest. Petitioner characterizes this note as recourse in nature.

Additionally, petitioner agreed to pay $1.00 per unit to the Advertising Pool for each unit sold within petitioner's marketing area.

Finally, on December 20, 1978, petitioner entered into a "Sales and Marketing Agreement" with New Marketing Concepts, Incorporated ["New Marketing Concepts"]. Through the Sales and Marketing Agreement, petitioner appointed New Marketing Concepts as his exclusive marketing agent to promote, market, distribute and sell the product within the marketing area. In consideration for its services, petitioner was to pay New Marketing Concepts a nonrefundable fee of $30,750, payable $2,050 ($50 times 41 units) in cash, $3,075 ($75 times 41 units) through a promissory note due March 15, 1979, at six percent interest and $25,625 ($625 times 41 units) through a nonrecourse promissory note due and payable

December 31, 1985, at six percent interest. Petitioner characterized the $3,075 note as recourse.

On December 20, 1978, petitioner signed a check payable to Bio-tronics in the amount of $12,300._3/ Petitioner has never been involved in the business of marketing, promotion, distribution or sale of medically-related products.

On December 20, 1978, Aldridge wrote petitioner that Aldridge would arrange for the sale and transfer of ownership of the Proctotherm license for Area 65 no later than March 15, 1979, for total consideration of "second year" cash payments.

While it is not clear when the U.S. patent was obtained on the Proctotherm, the device did not become marketable until 1981. While

---

3 The $12,300 check constitutes the cash payments of $10,250 and $2,050 under the License Agreement and Advertising Pool Agreement, respectively. From the record, we determine that petitioner never made the cash payment of $2,050 to New Marketing Concepts under the Sales and Marketing Agreement.

the company applied to the Federal Drug Administration ("FDA") in 1977 or 1978 for approval to market the device, Bio-tronics did not receive conditional approval to market the device until 1981._4/ The conditions on the sale of Proctotherm were removed in 1982. While a few thousand Proctotherm devices have been sold to date, no devices have been sold in Area 65. Bio-tronics has never sustained a profitable year.

On his 1978 return, petitioner deducted the following in respect to his Proctotherm license on Schedule C:

Amortization of license fee	$23,062
Marketing contract	30,750
Advertising	2,050
Interest	2,030
	$57,892

As no income was realized from the Proctotherm distributorship, petitioner recorded a $57,892

---

4 Conditional approval meant that the FDA required that a patient's use of the Proctotherm require a physician's prescription and informed consent by the patient.

net loss from the medical equipment distributorship. Petitioner recognized no income and claimed no further deductions for the Proctotherm distributorship on subsequent returns.

In his statutory notice of deficiency, respondent allowed only $46,498 of the $57,892 deductions claimed by petitioner on his 1978 return as ordinary and necessary business expenses. Respondent further asserts that in 1979 petitioner was entitled to an interest expense deduction of $11,510 which was no claimed on the return. In 1980, respondent asserts that petitioner has realized income of $45,707.31 from the discharge of accrued liabilities.

However, in his amendment to answer_5/ filed November 5, 1984, respondent alleges that, since petitioner was not in the trade or business of marketing the Proctotherm device during the years in issue and petitioner did not engage in the activity to make a profit,

---

5 Rule 41(a), Tax Court Rules of Practice and Procedure.

petitioner is entitled to no deductions in 1978 and no interest deduction in 1979._6/

Oil and Gas Interest

Petitioner obtained an undivided one percent of a 73 percent net lease interest in two oil and gas leases. Petitioner's interests are known as Weimen No. 29-1 and Ludwig No. 20-1 (the "properties"). J & D Enterprises assigned these one percent interests in the properties to petitioner. J & D Enterprises purchased these interests from L. G. Williams Oil Company ("L. G. Williams")._7/ Under a "Letter Agreement" dated June 25, 1979, between petitioner and L. G. Williams, petitioner agreed to pay all invoices from L. G. Williams if L. G. Williams drills a well on each of the properties. If petitioner does no pay the invoices within ten days, petitioner

---

6 This is a deduction that respondent raised in the statutory notice of deficiency.

7 These agreements appear to be signed on August 7, 1980, contrary to the testimony of petitioner that he purchased his interest in 1979. Nevertheless, petitioner paid J & D Enterprises $10,760 on October 1, 1979.

may forfeit his interests in the wells.

On October 1, 1979, petitioner wrote a check payable to J & D Enterprises in the amount of $10,760. On February 2, 1982, and June 23, 1982, petitioner received past due notices from L. G. Williams for the amounts of $14,223.61 and $14,396.59, respectively.

Petitioner made a timely election under section 263(c)_8/ and section 1.612-4, Income Tax Regs., to deduct intangible drilling and development costs currently for Federal income tax purposes. Petitioner made the election on his 1979 return.

In his statutory notice of deficiency dated September 28, 1982, respondent disallowed the $10,168 which petitioner deducted on his 1979 return for depreciation,_9/ intangible

---

8 All section references are to the Internal Revenue Code of 1954, as amended and as in effect during the years at issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

9 Petitioner reported his depreciation on this drilling interests in 1979 as follows:

Property	Date Acquired	1979 Depreciation

drilling costs, intangible completion costs, administrative expenses and miscellaneous expenses in connection with his interest in Weimen No. 29-1 and Ludwig No. 20-1. In connection with petitioner's 1980 return, respondent disallowed petitioner's deduction for depreciation of $300._10/

OPINION

Before determining to what deductions, if any, petitioner is entitled in relation to his Proctotherm license and his Oil and Gas Interests, we must initially determine whether petitioner is a cash basis taxpayer with respect to both activities. Respondent assumes in his arguments that petitioner is a

---

Girard	11-79	$26
Ludwig	11-79	45
Weimen	11-79	32

10 We cannot tell how petitioner reported his depreciation on his drilling interest in 1980. Schedule C, on which petitioner deducts $300.00 in depreciation, refers to Schedule 6 for allocation. No schedule 6 exists on the record for taxable year 1980.

In 1980, petitioner reported income of $863.86 from his oil and gas interests.

cash basis taxpayer. On the other hand, petitioner states that petitioner's tax returns filed for the taxable years 1978, 1979 and 1980 were prepared and filed on the accrual method of accounting.

Section 446(a) requires taxable income to be computed "under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." If the taxpayer has not regularly used a method of accounting, "the computation of taxable income shall be made under such method, as in the opinion of the Secretary, does clearly reflect income." Sec. 446(b). If the taxpayer has regularly used a certain method of accounting, the taxpayer must secure the consent of the Secretary before changing the method of accounting. Sec. 446(e). However, a taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade and business. Sec. 446(d). Section 1.446-1(d)(1), Income Tax Regs., states:

> Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each clearly reflects income of the particular trade or business * * *. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter. [Emphasis supplied.]

With respect to the Proctotherm license, petitioner first reported deductions for the taxable year 1978 and his 1040 income tax return.__11/ On Line E of his Schedule C, petitioner indicated that he reported income and deductions based upon the cash method of accounting by placing an "X" in the box next

---

11 Petitioner filed two amended 1040 returns for the taxable year 1978. However, the changes made in the returns do not involve deductions with respect to his Proctotherm license or his Oil and Gas interests.

to "Cash". In 1979, petitioner first reported deductions with respect to his oil and gas activity. Again, petitioner indicated that he reported income and deductions based on the cash method of accounting by placing an "X" in the box next to "Cash" on line E of Schedule C. In 1980, petitioner deducted $300.00 in depreciation with respect to his drilling interest and once again, he indicated that he used the cash method of accounting on Line E of Schedule C.

Petitioner submits that he is entitled to a deduction on an accrual basis because, in his farming business, he deducted expenses paid by the means of a promissory note. Even if petitioner used the accrual method with respect to his farming business, a question we decline to consider, petitioner's accounting method with respect to farm income is in relation to a separate trade or business and thus has no bearing on our decision in light of section 446(e) and 1.446-1(a)(1), Income Tax Regs. On the basis of the record before

us, we conclude that petitioner was required to report under the cash method of accounting with respect to his Proctotherm license and his Oil and Gas Interests. However, this conclusion does not reflect or infer that we find either the Proctotherm license or oil and gas interest to be a "trade or business" under section 162.

Medical Equipment License

Respondent makes several arguments to support his denial of petitioner's deductions associated with the Proctotherm License. First, respondent asserts that petitioner is not entitled to deduct any expenses with respect to the Proctotherm License because he did not engage in the activity to make a profit. Second, respondent states that since petitioner did not engage in the activity to make a profit and was not engaged in the trade or business of marketing the Proctotherm device, petitioner is not entitled to the deduction of $23,062 for the cost of the license pursuant to section 1253(d). Third,

respondent asserts that petitioner realized income in 1980 in the amount of $45,707.31 from the discharge of accrued liabilities. Finally, respondent states that petitioner, as a cash basis taxpayer, may only deduct interest expense which is actually paid.

Except for the argument relating to the cancellation of indebtedness income, respondent bears the burden of proof on all arguments due to the fact that respondent raised these arguments in his amendment to his answer. Rule 142(a). Based upon our determination herein, we need not address respondent's remaining alternative arguments. Since respondent's profit-motive arguments, if accepted, would be largely dispositive of the license deductions before us, we will first address those issues.

Section 183(a) provides that if an individual's activity constitutes an activity "not engaged in for profit," the deductions arising out of such activity shall not be allowed except as provided in 183(b). An

"activity not engaged in for profit" is defined in section 183(c) as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212." If the activity is not engaged in for profit, section 183(b) separates the claimed deductions into two groups. Section 183(b)(1) allows only those deductions which are not dependent on profit motive. Section 183(b)(2) provides that deductions which would be allowed only if the activity is engaged in for profit shall be allowed, but only to the extent that the gross income from the activity exceeds the deductions otherwise allowable under section 183(b)(1).

Section 162(a) allows as a deduction all the necessary and ordinary expenses paid or incurred during the taxable year in carrying on any trade or business. In order to constitute the carrying on of a trade or business under section 162, an activity must be entered into with an actual and honest

objective to make a profit therefrom. Herrick v. Commissioner, 85 T.C. 237, 254 (1985); Dreicer v. Commissioner, 78 T.C. 642 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963), affg. a Memorandum Opinion of this Court. 12/ Profit in this context means economic profit, independent of tax savings. Surloff v. Commissioner, 81 T.C. 210 (1983).

The issue of whether a taxpayer engages in an activity with the requisite profit objective is one of fact to be resolved on the basis of all the surrounding facts and circumstances. Sec. 1.183-2(b), Income Tax Regs.; Engdahl v. Commissioner, 72 T.C. 659 (1979); Allen v. Commissioner, 72 T.C. 28 (1979). In determining whether an activity is engaged in for profit, the following factors are to be considered: (1) the expertise of the taxpayer in carrying on the activity; (2)

---

12 See also Brannen v. Commissioner, 722 F.2d 695 (11th Cir. 1984), affg. 78 T.C. 471 (1982); Hager v. Commissioner, 76 T.C. 759 (1981), and cases cited therein.

the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profit, if any, which is earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. Sec. 1.183-2(b), Income Tax Regs., Royer v.Commissioner, 69 T.C. 521 (1977); Benz v. Commissioner, 63 T.C. 375 (1974). It is not intended, however, that only the aforesaid factors be taken into account in making the determination. Sec. 1.183-2(b), Income Tax Regs. No single factor is determinative and the issue is to be resolved by examining all the circumstances. Fuchs v. commissioner, 83 T.C. 79, 98 (1984); Dean v. Commissioner, 83 T.C. 56, 74 (1984); Flowers v. Commissioner,

80 T.C. 914, 31 (1983); Dunn v. Commissioner, 70 T.C. 715, 720 (1978), affd. 615 f.2d 578 (2d Cir. 1980). In our determination, we ascribe greater weight to objective factors than to mere after-the-fact statements of intent. Fuchs v. Commissioners, supra; Siegel v. Commissioner, 78 T.C. 659, 699 (1982); Engdahl v. Commissioner, supra.

Turning to the record before us, an examination of the factors listed in Section 1.183-2(b) is illuminating. First, petitioner admits that he carried on no profit-directed activity. Moreover, the mere execution of the necessary paperwork to acquire a territorial license does not constitute a trade or business. Herrick v. Commissioner, supra. Second, petitioner concedes that although he does have some experience in retail sales, he has no expertise in the business of marketing, promotion, distribution and sales of any medically-related products. Petitioner testified that he believed the Proctotherm device was "feasible" based solely on his

knowledge as a sufferer of hemorrhoids. Third, petitioner admits that he spent no time or effort in carrying on the activity. Fourth, petitioner had no expectation that the assets used in the activity would appreciate in value._13/ Fifth, although involved in retail sales of real estate, petitioner has no experience i the distribution of medical devices. Sixth, petitioner claimed no income in respect to his Proctotherm distributorship for the taxable year 1979 and claimed deductions amounting to $57,892.00 in that taxable year. Petitioner did not attach a Schedule C for his distributorship to either his tax returns for the taxable years 1979 and 1980. Seventh, no profits were ever earned by the distributorship. Eight, petitioner's financial status was such that he considered himself a suitable applicant for a Proctotherm license. The Bio-tronics application for the Proctotherm license stated

---

13 In an effort to evade liability and thus limit his interest in the activity, petitioner had Aldridge mark the $25,625 New Marketing Concepts note as "nonrecourse."

that:

> this type of business is generally not suitable for persons who do not possess substantial annual income (i.e. in excess of $100,000,00) or substantial annual income (i.e.adjusted gross income subject to Federal income tax at a rate of 40% or higher), do you believe that you are a suitable applicant?

On his application, petitioner answered "yes" to this question. We believe a reasonable inference from this response in context with other statements in the record_14/ is that in entering this deal, petitioner's primary focus centered on the tax-savings aspects of the Proctotherm license rather than the deal's profit potential. Finally, there is obviously

---

14 The record does not contain the tax opinion which accompanied the Bio-tronics application; however, in a letter from Aldridge to petitioner on December 3, 1975, Aldridge urged petitioner not to sell his license of Area No. 65 because "the tax deductions for that area will be higher" in 1979 than "originally anticipated." In fact, instead of a 1.62 to one ratio of tax benefits, Aldridge projects a 2.46 to one write-off for petitioner in 1979.

no element of personal pleasure or recreation involved i this case._15/

Petitioner argues that his primary motivation in entering into the Proctotherm license was to make a profit. Petitioner's credibility is not altogether convincing. Petitioner's testimony was often confused, ambivalent, and equivocal. Thus, we need not accept petitioner's self-serving, uncorroborated testimony. Moreover, petitioner admits that another purpose of making the investment in Bio-tronics was to obtain deductions in the taxable year 1978. We believe that petitioner did not learn that the Proctotherm patent did not exist at the time of the license agreement and that FDA approval had not been obtained until after he bought the license. However, such evidence serves to highlight that in making is decision to invest in the Proctotherm license, petitioner did not independently investigate the existence of the patent and

---

15 In this respect we empathize with petitioner's status as a "sufferer of hemorrhoids."

FDA approval, or the qualifications of the inventors of the Proctotherm device or the management of Bio-tronics or New Marketing Concepts. Petitioner did not check on the patent and FDA status of the Proctotherm device after speaking to Aldridge in December, 1978. Rather, in a letter dated March 9, 1979, Bio-tronics, apparently on its own initiative, informed petitioner that the patent had not yet been obtained. Failure to make such elementary inquiries and to obtain expert advice in a transactio of this magnitude is not consistent with ordinary sound business practice, and may no be regarded as evidence that petitioner lacked a profit motive. See Herrick v. Commissioner, supra; Flowers v. Commissioner, supra; Surloff v. Commissioner, supra; compare Waddell v. Commissioner, 86 T.C. 848 (1986). Finally, on the day he signed the License Agreement and paid the cash requirements, Aldridge agreed o petitioner's request to sell petitioner's interest in early 1979. In his petition, petitioner states that

this agreement's effect was that he would have his costs "expended in 1978 and recapture and declare in 1979 the sale price of the amount of the notes." This arrangement smacks of nothing but motivation for tax avoidance.

From a close examination of the entire record, we find that respondent has met his burden of proof and find that petitioner's Proctotherm distributorship was not an activity engaged in for profit. Consequently, we hold that petitioner is not entitled to business deductions under section 162 due to the absence of profit motive and objective.

Having determined the profit objective issue, we now consider the payments made by petitioner for his Proctotherm license. Respondent asserts that petitioner is not entitled to an amortization deduction pursuant to section 1253(d) where petitioner has not entered the trade or business. We agree.

Section 1253(d) governs the treatment of payments made by a transferee of a franchise.

16/ If the payments are "contingent on the productivity, use, or disposition of the franchise," section 1253(d)(1) provides that such payments are deductible within the meaning of section 162. If the payments made by transferee are not contingent, section 1253(d)(2) governs the tax treatment of such payments. Section 1253(d)(2) provides the period over which a transferee may deduct fixed payments depending on whether the license obligation is paid off with a single payment, approximately equal payments, or by any other arrangement for payment. Section 1253(d)(2)(B) provides for the deduction through amortization of acquisition payments over the period of the transfer agreement or a period no longer than ten years. Sec. 1253(d)(2)(B). On his 1978 return, petitioner amortized his license over eight years,

---

16 The term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specific area. Sec. 1253(b)(1).

deducting $23,062 ($184,500 divided by eight) on his Schedule C._17/ Petitioner's initial $10,250 cash payment, the $12,300 promissory note, and the $161,950 nonrecourse note are payments involved in the section 1253(d)(2) amortization deduction._18/

Section 1253(d)(1) specifically provides that amounts paid or incurred as therein described "shall be allowed as a deduction under section 162(a) (relating to trade or business expense)." Section 1253(d)(2) does not contain a reference to section 162, or to any other section of the Code. However, in Herrick v. Commissioner, supra, this Court held that, in light of the legislative history of section 1253,_19/ section 1253(d)(2) embodies

---

17 On his return, petitioner erroneously stated that he amortized his license fee over seven years under the straight line method.

18 See our discussion infra, beginning on p. 22 where we hold that the $12,300 promissory note and the $161,950 nonrecourse note are not genuine indebtedness.

19 See H. Rept. 91-413 (1969), 1969-3 C.B. 200, 302; S. Rept. 91-552 (1969), 1969-3 C.B. 423, 557.

a trade or business requirement despite the absence of a specific reference thereto._20/ Herrick v. Commissioner, supra at 266. Thus, in order for petitioner to deduct his license fee payments under section 1253(d)(2), petitioner must be operating or conducting a trade or business after the payments are made.

Earlier in this opinion, we found that petitioner was not entitled to business deductions under section 162 with respect to his Proctotherm distributorship because petitioner did not possess the requisite profit objective. The mere signing of an agreement for the transfer of a franchise or distributorship and payment of the acquisition or initial fees, do not, ipso facto, entitle the taxpayer to a deduction. Herrick v. Commissioner, supra at 266. On the basis of our previous finding, we hold that petitioner is not entitled to amortize any part of the Proctotherm license acquisition fee under

---

20 Powell v. Commissioner, T. C. Memo. 1986-369.

section 1253(d).

We now turn to respondent's assertion that petitioner realized $45,707.31 in cancellation of indebtedness income due to the discharge of accrued liabilities._21/ On this issue we hold for the petitioner.

First, at trial and on brief, we note that respondent concedes the cancellation of indebtedness issue if we find that petitioner is not entitled to any deductions with respect to the Proctotherm activity during 1978 or 1979. We have denied all of petitioner's deductions with respect to the Proctotherm activity under 162 and 1253, and we agree with respondent that no cancellation of indebtedness issue exists for the following reasons.

With respect to the five notes executed-

---

21 Respondent calculated the $45,707.31 amount as follows:

Accrued Advertising Expense, Bio-tronics Note	$ 3,075.00
Accrued Marketing Expense, New Marketing Note	28,700.00
Accrued Interest	11,882.31
Other Accrued Marketing Expense	2,050.00

by petitioner in connection with the Proctotherm activity, we find that petitioner does not have indebtedness within the meaning of section 61(a)(12) because we determine that the five notes do not constitute genuine liabilities of petitioner. We have determined that petitioner was not engaged in a trade or business under sections 162 and 1253 because he lacked the requisite profit objective. We have further scrutinized the overall Proctotherm licensing activity to ascertain whether its form comports with economic reality. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). Upon careful inquiry, we determine that the entire Proctotherm license was not authentic in substance and that the loan transactions had no genuine "purpose, substance, or utility apart from their anticipated tax consequences." Goldstein v. Commissioner, 364 F.2d 734, 740 (2d Cir. 1966), affg. 44 T.C. 284 (1965), cert. denied 385 U.S. 1005 (1967).

_22/

We are satisfied that the two nonrecourse notes which petitioner executed have no economic substance._23/ Although the notes carried a due date of December 31, 1985, the notes looked primarily to the sale of the Proctotherm device for payment. However, there was no patent or FDA approval for the Proctotherm at the time of the execution of the notes nor for almost three years after that date. The notes were not carried as an asset on the balance sheet of Bio-tronics, but are only noted in an auditor's statement.

Moreover, we determine that the remaining three notes which petitioner executed are nonrecourse as well._24/ As stated in the

---

22 See also Knetsch v. United States, 364 U.S. 361 (1960); Falsetti v. Commissioner, 85 T.C. 332 (1985).

23 These notes are the $25,625 note payable to New Marketing Concepts due December 31, 1985 and the $161,950 note payable to Bio-tronics, Inc. due December 31, 1985.

24 These notes constitute the promissory note pursuant to the Advertising Pool Agreement in the amount of $3,075 due May 15, 1979, the

Security Agreement, petitioner "in no event" is personally liable for the "obligations and liabilities under the License Agreement." We read "obligations and liabilities under the License Agreement" to include the promissory notes executed pursuant to the Sales and Marketing Agreement. Furthermore, although the three notes were over five years delinquent at trial, no legal action had been or was being taken to enforce the notes. Additionally, the notes were not carried as an asset on the books of the corporation. Accordingly, we conclude that the notes are without substance and do not constitute a true liability of petitioner.

Since we have found that these notes impose no liability obligation on petitioner, we determine, a fortiori, that there is no cancellation of indebtedness income therefrom

---

promissory note pursuant to the License Agreement in the amount of $12,300 due March 15, 1979, and the promissory note pursuant to the Sales and Marketing Agreement in the amount of $3,075 due March 15, 1979. Petitioner characterizes these notes as recourse liabilities.

to petitioner under section 61(a)(12). Thus, we hold for petitioner and deny respondent's assertion that petitioner realized income in 1980 in the amount of $45,707.31.

Finally, we must determine if petitioner is to be allowed any deductions under section 183(b). Section 183(b)(1) allows deductions otherwise allowable without regard to whether or not an activity is engaged in for profit. Section 163 provides that a deduction shall be allowed for all interest paid or accrued on indebtedness within the taxable year.

Petitioner executed two nonrecourse promissory notes and three interest bearing promissory notes regarding his distributorship. We have held that these notes do not constitute true indebtedness._25/ Petitioner testified that he made no cash payments of either interest or principal on any promissory notes. However, petitioner accrued interest expense on his 1978 return of $2,030.

---

25 See our discussion, supra, beginning on page 22.

We hold that petitioner is not entitled to deduct interest expenses in 1978 for two reasons.

First, in order for interest to be deductible under section 163(a), it must be paid on genuine indebtedness. Knetsch v. United States, 364 U.S. 361 (1960); Narver v. Commissioner, 75 T.C. 53, 98 (1980), affd. 670 F.2d 855 (9th Cir. 1982). Where transactions lack substance and are entered into solely to form the basis of a tax deduction, they need not be recognized. Battelstein v. Internal Revenue Service, 611 F.2d 1033, 1035 (5th Cir. 1980); Goodstein v. Commissioner, 30 T.C. 1178 (1958), affd. 267 f.2d 127 (1st Cir. 1959). We have found that petitioner's notes with respect to the Proctotherm activity lacked economic substance and were entered into solely to form the basis of tax deductions. Accordingly, we hold that petitioner may not deduct interest on such notes under section

163(a). 26/

Second, petitioner, as a cash basis taxpayer, may only deduct amounts that petitioner paid during the taxable year. It is hornbook tax law that a cash basis taxpayer may deduct expenses only in the year paid. Sec. 1.461-1(a)(1), Income Tax Regs.; Helvering v. price, 309 U.S. 409 (1940). The accrual of interest expense is clearly inconsistent with the cash method of accounting. Deductions allowed for interest expense under section 163(a) must be limited to actual amounts paid. Petitioner paid no interest expense in 1978, 1979, or 1980 and correlatively, no interest expense is deductible.

Section 183(b)(2) allows deductions "to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable" by section 183(b)(1). We need not address application of this

---

26 See Surloff v. Commissioner, 81 T.C. 210, 242 (1983).

section to the circumstances extant as there is no gross income derived from the activity in the taxable year in questions and we have allowed no deductions under section 183(b)(1).

In sum, all deductions taken by petitioner in respect to his Proctotherm activity are denied for the taxable year 1978. We also deny the deduction for interest expense for the taxable year 1979 raised by respondent in his statutory notice of deficiency and later denied by respondent in his amendment to answer. However, we hold that petitioner does not have cancellation of indebtedness income from the discharge of accrued liabilities for the taxable year 1980.

Oil and Gas Interest

In his statutory notice of deficiency, respondent denied petitioner's deductions for depreciation, intangible drilling costs (sometimes hereinafter referred to as "IDC"), administration expenses, and miscellaneous expenses of $10,168 because petitioner did not

establish that the alleged expenditures relating to two oil and gas wells were incurred by L.G. Williams Oil Company, or were paid for by petitioner. Respondent has also denied petitioner's deduction for depreciation of $300 in 1980 on the same grounds. Petitioner alleges that, in addition to the $10,168 payment, he is entitled to a $14,500 drilling deduction in either 1979, or 1980 for which L.G. Williams billed him and which he has not paid._27/

Section 263(c) authorizes a taxpayer to elect to deduct intangible drilling and development costs as expenses in accordance with regulations prescribed by respondent. Section 1.612-4, Income Tax Regs., which implements section 263(c), provides an option to capitalize or to deduct currently intangible drilling expenses incurred in the development of as or oil properties. The election is available only to

---

27 The $14,500 amount is not claimed on petitioner's return but is raised in his petition. Petitioner later changes the amount of the deduction to $14,223 in his reply brief.

an "operator", who is defined as one who holds a working or operating interest in any tract or parcel of land either as a full owner or under a lease or any other form of contract granting working or operating interest. It is not sufficient if a taxpayer merely supplies the money to pay for drilling in exchange for an oil payment. In such cases, the taxpayer would have to capitalize his expenditures as acquisition costs of a nonoperating interest. Burns v. Commissioner, 78 T.C. 185 (1982). Section 1.612-4(c), Income Tax Regs., provides in part that:

> The option granted * * * to charge intangible drilling and development costs to expense may be exercised by claiming intangible drilling and development costs as a deduction on the taxpayer's return for the first taxable year in which taxpayer pays or incurs such costs * * *.

If a taxpayer elects to expense intangible drilling costs then the appropriate year of deduction is determined pursuant to section

461 and the regulations thereunder. Stradlings building materials, inc. v. Commissioner, 76 T.C. 84, 86 (1981).

More particularly, this Court in Stradling has set forth four criteria which taxpayer must satisfy in order to qualify for the option under section 1.612-4(a), Income Tax Regs. Stradling, supra at 89. First, the taxpayer must hold an operating or working interest in the property under development. Second, the costs in question must relate to the development of the property in which the taxpayer has a working or operating interest. Third, the nature of the expenditure must fall within the definitional guidelines provided by section 1.12-4(a), Income Tax Regs. Finally, the payment or incurrence of the costs must occur sufficiently early in the development stages so that the taxpayer is exposed to the unknown risks of development.

Thus, to determine if petitioner is eligible to deduct any IDC expense in 1979 and 1980, we must make two inquiries. First, we

must determine if petitioner made a timely election to deduct his expense in a year appropriate to his method of accounting. Second, we must determine if petitioner met the four criteria to qualify for the option to expense IDC costs under section 1.61204(a), Income Tax Regs.

Respondent's determination of the deficiency is presumptively correct. Welch v. Helvering, 290 U.S. 111, 115 (1933). In order to overcome this presumption, petitioner must offer evidence that shows the determination is erroneous. Guersten v. Commissioner, 267 F.2d 195, 199 (9th Cir. 1959), affg. in part 28 T.C. 756 (1957). Petitioner bears the burden of proving entitlement to the claimed deduction. Rule 142(a).

The law is well settled that tax deductions are a matter of legislative grace. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). Petitioner, when referring to section 263(c) to justify his deductions, must

establish that he falls within its terms. Roberts v. Commissioner, 62 T.C. 8334, 836 (1974). Here, we find that petitioner has not met his burden of proof for the following reasons.

First, petitioner has properly elected to expense IDC costs in 1979. However, since we have found that petitioner is a cash basis taxpayer for purposes of the drilling activity, he can only deduct expenses for which he has actually paid or suffered an economic detriment. Sec. 1.46101, Income Tax Regs.; Levy v. Commissioner, 732 F.2d 1435 (9th Cir. 1984), Affg, a Memorandum Opinion of this Court. Since petitioner has paid the sum of $10,760 to J & D. Enterprises and deducted $10,168 on his 1979 return, we must determine if petitioner satisfied the four criteria of section 1.162-4, Income Tax Regs., as to the $10,168 deduction amount. We need not consider the $14,223 deduction which petitioner raised in his petition before the Court, because, as a cash method taxpayer, petitioner is not entitled to a deduction as he has not paid or

suffered an economic detriment as to this amount.

We hold that petitioner does not meet all four criteria necessary to qualify for the option to expense IDC costs under section 1.612-4(a), Income Tax Regs., with respect to the $10,168 deduction on his 1979 return.

Initially, on the facts before us, it is not clear if petitioner owns an operating or working interest in the properties. The parties have stipulated that petitioner obtained an interest in two oil and gas leases from L.G. Williams on or about June 25, 1979. Petitioner entered into a Letter Agreement with L.G. Williams on June 25, 1979, by which L.G. Williams agreed to drill a well on each of the properties. Petitioner agreed to pay all invoices submitted to him by L.G. Williams. Petitioner paid J & D Enterprises $10,760 on October 1, 1979. However, there is no evidence of what this payment is for or why petitioner paid this amount of J & D Enterprises instead of the driller L.G. Williams. Petitioner's testimony on this matter is

confused and equivocal. Moreover, the assignment of these interests in these properties to petitioner from J & D Enterprises was signed on August 7, 1980. As a result, we cannot determine when petitioner acquired his interest in the properties, if petitioner acquired an interest, or what kind of interest he acquired.

More importantly, petitioner does not satisfy the three other Stradling criteria. First, petitioner does not relate the $10,168 of claimed expenses to the properties in which he has an interest. Second, petitioner has not shown that his expenditure satisfies the definitional guidelines of section 1.612-4(a), Income Tax Regs._28/ Finally, given the lack

---

28 In general, Drilling and Development Costs must be allocated between tangible and intangible costs in order to determine what is properly expensed. See Levy v. Commissioner, 732 F.2d 1435, 1438 (9th Cir. 1984). Levy is distinguishable from our case in that in Levy the parties stipulated to the amount of tangible and intangible cost incurred. In Levy, the taxpayer conceded that his costs must be allocated between tangible and intangible costs in order to determine what may be expensed. The issue in Levy revolved

of evidence presented by petitioner at trial, we cannot determine if the payment or incurrence of the drilling costs occurred sufficiently early in the developmental stages of the well so that the taxpayer is exposed to the unknown risks of development.

Turning to the facts before us, petitioner has not shown how he arrived at the figures deducted on his return. On his 1979 return, on Schedule No. 6, petitioner give tangible costs not only for the Ludwig and Weimen wells by for "Girard", presumably another well. On his 1979 return, petitioner states that he acquired Girard in 1979 but neither party makes mention of this interest. The Court also received into evidence a billing to J & D

---

around whether the amount of Levy's cash contribution in his partnership interest must be allocated between tangible and intangible costs. The Ninth Circuit agreed with this Court's determination that since the sum of IDC's expended exceeded Levy's cash investment, Levy may expense IDC's to the extent of his cash investment. Levy v. Commissioner, supra at 1438. Here petitioner has not proven that he incurred IDC expense and, as a result, we cannot reach the Levy analysis.

Enterprises from L.G. Williams listing numerous tangible and intangible drilling and completion costs in addition to miscellaneous and administrative expenses. Petitioner has not explained these figures or correlated these expenses to those claimed on the return. We cannot find any true correlation and, as a result, do not known what the $10,760 payment to J & D Enterprises represented nor can we substantiate the items that constitute the $10,168 worth of deductions.

While we cannot determine if petitioner acquired a working interest in the properties, we note that oil and gas interest in which the working interest and drilling contract are available in one package deal are subject to close scrutiny. Bernuth v. Commissioner, 470 F.2d 710 (2d Cir. 1972), affg. 57 T.C. 225 (1971). In such a situation, the availability of the intangible drilling cost option provides a strong incentive to overstate the drilling costs and minimize the cost of the working interest. Bernuth v. Commissioner, 470

F.2d at 715. Thus, the difference between the deductible drilling costs and the total amount paid may well be attributable to capital cost of the total package purchased, including not only the reasonable value of the lease acquired by also disguised premiums to promoters and promotional charges. Bernuth v. Commissioner, supra. While the Assignment of Interest in the wells from J & D Enterprises to petitioner stated that petitioner paid "ten dollars, and other valuable consideration" for the interest, the mere entry into evidence of these terms does not overcome the presumption of correctness given to the Commissioner's deficiency determination. Bernuth v. Commissioner, 470 F.2d at 716. No specific allocation of the purchase price was made in any documents before the Court. Petitioner presented no evidence as to the value of the leases or his interest. It appears that J & D Enterprises was experienced and skilled in locating oil and gas property and petitioners benefitted therefrom in investing through J &

D Enterprises. This alone creates an inference that the leases had some value._29/

Petitioner cites Keller v. Commissioner, 79 T.C. 7 (1982), affd. 725 F.2d 1173 (8th cir 1984), in support of his position that he is entitled to the claimed drilling deductions. Keller is distinguishable from petitioner's case. In Keller, the Court stated a three-part test to determine the current deductibility of prepaid IDC for cash basis taxpayers. However, in Keller, respondent accepted that IDC's had been incurred. The key issue was in which year the deduction for IDC should be allowed. Keller v. Commissioner supra at 27. Here, we cannot reach the Keller analysis because we have no knowledge that the payments were for IDC's. See Keller v. Commissioner, 725 F.2d at 1175.

Petitioner brought forward no witnesses

---

29 See Roby v. Commissioner, T.C. Memo. 1983-688. We distinguish Hedges v. Commissioner, 41 T.C. 695 (1964). In Hedges, we found all costs incurred were IDC. Here, we are unable to determine this on the basis of the evidence.

from J & D Enterprises or L.G. Williams to verify his deductions and presented no evidence to clarify and substantiate how he arrived at the figures which he deducted. Nothing in the record provides a tenable explanation for the allocations made on the tax return of petitioner. We need not accept petitioner's self-serving, uncorroborated testimony. Petitioner's evidence is inconsistent and incomplete. We find the same shortcoming with respect to petitioner's 1980 deduction for depreciation. We have considered all of petitioner's arguments and find them unpersuasive.

On the basis of the record, we hold that petitioner has failed to carry the burden that respondent's denial of all drilling deductions is erroneous. Accordingly, we sustain respondent's denial of petitioner's deductions for depreciation, intangible drilling costs, intangible completion costs, and miscellaneous expenses in 1979 and 1980.

To reflect the foregoing,

Decision will be entered

under Rule 155.

EXHIBIT #3

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

CLAYTON E. DEVOE,	)	
	)	No. 87-7372
Petitioner-Appellant,	)	Tax Ct. No. 0977-6
	)	
vs.	)	ORDER_1/
	)	
COMMISSIONER INTERNAL REVENUE SERVICE,	)	FILED DEC. 2, 1988
Respondent-Appellee.	)	
	)	

Before: BROWNING, WALLACE, BRUNETTI, Circuit Judges.

Appellant's petition for rehearing is denied.

1/ This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 36-3.

EXHIBIT #4

WSR:GRA:RSPomerance:rn
5-17183
CMN 8730288

January 6, 1989

George Curtis DeVoe, Esquire
310 North Higgins
Suite 2
Missoula, Montana 59802

Re: Clayton E. DeVoe v. Commissioner
(9th Cir. - No. 87-7372

Dear Mr. DeVoe:

In your letter of December 9, 1988 to Mr. Pomerance of this office, you inquired whether it is our position that certain of the taxpayer's expenses can neither be capitalized nor deducted. As we understand it, the expenses in question are among those which the Tax Court held to be nondeductible for the years here in suit, 1978 through 1980. That decision, as you know, was affirmed by the Ninth Circuit on October 6, 1988, and we understand that your petition for rehearing has been denied. Thus, apart from any Supreme Court review, it has been decided in this litigation that no part of these expenses may be deducted or otherwise written off during the years in suit. However, the courts did not decide, and we at present take no position, whether these expenses or expenses of similar nature may be capitalized or deducted for a year other than the three involved in this suit. We do not mean to suggest that can or should be, only that the question simply is not presented in this litigation.

Sincerely yours,

William S. Rose, Jr.
Asst. Attorney General
Tax Division

By:
Gary R. Allen

Chief, Appellate Section
Tax Division
Department of Justice
P.O. Box 502
Washington D.C. 20044

CERTIFICATE OF SERVICE

I, J. Robert Riley, a member of the Bar of the the Supreme Court of the United States and counsel of record for Clayton E. DeVoe, Petitioner herein, certify that on the 13th day of February, 1989 pursuant to the rules of the Supreme Court, I served three copies of the foregoing Petition on each of the parties herein, as follows:

On Gary R. Allen, counsel for Respondent herein, by depositing such copies in the United States Post Office, Missoula, Montana, with first class postage prepaid, properly addressed to the post office address of Gary R. Allen, the aboved named Respondent's counsel of record, at P.O. Box 502, Washington D.C. 20044.

All parties required to be served have been served.

DATED this 13th day of February, 1989.

J. R. Riley

J.R. Riley, Esq.
Box 2013
Missoula, Montana 59806